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RIZONA CORPORATION COMMISSION

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JAMES M. IRVIN
COMMISSIONE
MARC SPITZER
COMMISSIONE

IN THE MATTER OF THE GENERIC PROCEEDINGS CONCERNING ELECTRIC RESTRUCTURING ISSUES.

DOCKET NO. E-00000A-02-0051

NOTICE OF FILING

The Arizona Utility Investors Association hereby provides notice of filing its response to the questions posed by the members of the Commission, as required by the procedural order in the above-captioned matter dated January 22, 2002.

DATED THIS 25TH DAY OF FEBRUARY, 2002.

WALTER W. MEEK, PRESIDENT

CERTIFICATE OF SERVICE

Original and ten (10) copies of the referenced response were filed this 25th day of February, 2002, with:

Docket Control
Arizona Corporation Commission
1200 W. Washington Street
Phoenix, AZ 85007

Copies of the referenced response were hand-delivered this 25th day of February, 2002, to:

William A. Mundell, Chairman
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ACC COMPETITION QUESTIONS

COMMISSIONER SPITZER'S QUESTIONS

1. In a vertically integrated utility model, what incentives (regulatory, financial and ratemaking) exist for the expanded use of renewable energies?

The Commission, as a part of its ratemaking function, can authorize a level of funding and/or a pass-through mechanism to encourage the use of renewables, either on the utility's system (i.e., solar thermal or photovoltaic generation) or for the end user (i.e., water heating). Of necessity, however, these efforts will not comprise a significant fraction of the total load and they will have to be subsidized because renewables are not now cost-competitive.

2. In a competitive electric model, what incentives exist for the expanded use of renewable energies?

For the UDC, the situation remains the same. In addition, the experience with retail competition in some jurisdictions (i.e., California and Pennsylvania) has indicated that there may be a distinct market among residential customers for green power produced from wind, solar, geothermal and other sources. The real potential of this market niche is unknown and there is a cost differential in the service. It must be recognized that renewables as a group have limited capabilities and usually do not fit neatly into a utility's load profile. Beyond that, the competitive model militates against renewables on a large scale because they are not cost-competitive.

3. In a vertically integrated utility model, what disincentives (regulatory, financial and ratemaking) exist for the expanded use of renewable energies?

Cost is the major disincentive, although the Commission's ability to provide subsidies and cushion the impacts is greater under the integrated model where the Commission maintains oversight over all of the elements of electric service during ratemaking. In the ratemaking context, large scale use of renewables would fail a prudence test.

4. In a competitive electric market utility model, what disincentives exist for the expanded use of renewable energies?

Cost again. Since the utility's generation assets may no longer be dedicated to serving its entire load, those assets must be able to compete in the open market. Except for niche marketing, generators have no incentive to use renewables. There is also a further disconnect for the Commission because its regulation becomes focused on the UDC which has little or no generation and theoretically is disinterested in its source of wholesale power. The probable regulatory response is a requirement that the UDC acquire a portion of its energy supply for standard offer customers from renewable resources.

5. During Arizona's period of reliance on the vertically integrated utility model, what renewable energy programs have been enacted in Arizona?

During the 1970s and 1980s, in response to national energy policies, a system of grants and tax incentives was enacted to encourage domestic use of solar energy, primarily to heat swimming pools and potable water. Utilities were involved in these programs in addition to their own beginning efforts to explore the viability of solar thermal, reflector and photovoltaic systems. When the national energy situation returned to normal, federal and state incentives faded and the solar energy industry contracted.

6. Since Arizona's adoption of a competitive electric market model, what renewable energy programs have been enacted in Arizona?

Apart from the Commission's continuing effort to implement a solar/ environmental portfolio standard, there are ongoing renewable programs at Arizona utilities, such as the landfill gas projects undertaken with local governments by SRP and TEP and APS' residential solar marketing program. Frankly, it is doubtful that the structure of the industry has had much to do with these programs.

7. Under the vertically integrated model, what incentives exist to build newer plants that are less damaging to the environment to replace older, dirtier plants?

We are constrained to suggest that "older" and "dirtier" are not synonymous and that the latter description is a term of art. Whether a plant is indeed "dirty" depends on its location and configuration, the population it affects and its use. For example, a peaking plant may be considered to be dirty because it uses petroleum fuel and is in a populated area, but if it runs only a few hours a year, there may be no measurable impact and there may be no viable alternative. Some people consider all coal plants to be dirty, but if they are equipped with the most advanced emission controls and are located away from population centers, it is arguable whether they produce negative impacts. If we assume that any plant operating today is in compliance with applicable environmental standards, there is no incentive to replace it unless a) it has reached the end of its useful life or b) major improvements in efficiency can be achieved. Of course, escalating emissions limits can produce the same effect.

8. Under the competitive electric model, what incentives exist to build newer plants that are less damaging to the environment to replace older, dirtier plants?

In the competitive environment, the economics of the plant is the key to its viability. Any plant, old or new, must achieve short run marginal costs that are competitive or it will not be dispatched. There may be investment credits and tax and accounting treatments (with which we are not familiar) that could tip the scales in favor of new construction, but in the end, operating efficiencies will rule. Typically, newer plants will be more efficient, but it's worth noting that in

those jurisdictions where divestiture of fossil-fueled plants was required, they were gobbled up by wholesale generators at multiples of their book value because the economics still worked.

9. Under the vertically integrated model, which disincentives (regulatory, financial and ratemaking) exist to build newer plants that are less damaging to the environment to replace older, dirtier plants?

Assuming, again, that the older plants are in compliance, the ratemaking regime simply does not contemplate removing from service plants that are used and useful and adding new facilities that are not needed to rate base. New plants that are built to serve growth will probably be more efficient and cleaner, but older plants will fulfill their useful lives unless environmental regulations undermine their operating efficiency significantly. We would also submit that it could be dangerous, in terms of economics and reliability, to sacrifice fuel diversity in order to achieve a marginal environmental gain.

10. Under the competitive electric market model, what disincentives exist to build newer power plants that are less damaging to the environment to replace older, dirtier plants?

As we noted in response to Question 8, it's a matter of economics. Newer plants should be more efficient, but market conditions may permit older plants to survive the cut on marginal cost.

11. During Arizona's period of reliance on the vertically integrated model, what emphasis did the Commission place on pollution control measures in Certificates of Environmental Compatibility? (a) What is the most stringent pollution control measure placed on a CEC during Arizona's reliance on the vertically integrated model?

The CEC requirements were added to Title 40 of the Arizona Revised Statutes in 1971, following enactment of the national Environmental Policy ACT and the creation of the Environmental Protection Agency. Many of Arizona's major power plants were already sited or under construction at that time. In addition, NEPA reserved to EPA the authority to set standards for large point sources such as smelters and power plants. We believe it is fair to say that the Commission largely ceded the application of pollution control measures to EPA or local agencies assigned to carry out EPA directives. AUIA cannot answer Question 11 (a) with any specificity.

12. Since Arizona's adoption of a competitive electric market model, what emphasis has the Commission placed on pollution control measures in Certificates of Environmental Compatibility? (a) What is the most stringent pollution control measure placed on a CEC since Arizona's adoption of a de-regulated utility model? (b) What is the likelihood that that measure would have been placed on a similar CEC in a vertically integrated utility model?

This question assumes that there may be a difference in regulation attributable to the differing market models. We don't think so. There is no question that this Commission has raised the bar significantly in applying environmental conditions on CECs for power plants and transmission lines. However, we think that is a function of the personalities and priorities of the Commissioners, not the prevailing market model. For example, AUIA will argue below that the most stringent application of pollution control measures to date was in the Santan CEC, a project submitted by a vertically integrated utility and designed to serve native load. It has nothing to do with the competitive model. The chief difference between past and present is that the gaggle of merchant plants applying for CECs are not owned by regulated utilities. The Commission has its sights trained on them because it gets only one shot at them in addition to the fact that some are being sited in atypical locations.
(a) We would argue that the combination of conditions banning the use of oil (even in an emergency) and requiring consideration of unknown future technologies at Santan is the most stringent pollution control measure to date. If this question weren't tied to pollution control, we would nominate the Arlington decision, mandating a specific cooling technology over the owner's objections.
(b) Again, we think the utility model is irrelevant. After all, the Commission doesn't regulate SRP or Duke under either model. If the question is whether some other Commission of our acquaintance would have imposed these measures, we doubt it, but times have changed.

13. During Arizona's period of reliance on the vertically integrated utility model, what amount of excess generating capacity existed in Arizona?

It is doubtful that anyone can provide a reliable answer to this question. Besides, excess capacity is in the eye of the beholder. It depends on what kind of generation it is, when the excess happens and a host of market factors. It is clear that Arizona's major utilities have had no kilowatts to spare in July and August in any recent year. We do know that planning reserves for regulated utilities used to be in the range of 18 to 20 percent and they are down to half of that today. That's the competitive market at work.

14. Since Arizona's adoption of a competitive electric market model, what amount of excess generating capacity existed in Arizona?

See the answer to Question 13, with this added comment: The concept of excess capacity is largely irrelevant in a competitive market, since the risk falls entirely on the producer. However, in an apparent perversion of market theory, "excess" capacity is being created in Arizona every day with the construction of power plants that may have no access to Arizona load centers and may or may not have access to viable markets elsewhere. In essence, in opposing APS' application for a variance to the Competition Rules, the merchant generators are asserting that the Commission is now responsible for the disposition of this capacity, which, of course, is absurd. The Commission has a responsibility to Arizona consumers and to the companies it regulates. It has no responsibility to companies that it doesn't regulate.

COMMISSIONER IRVIN'S QUESTIONS

SECTION I. Arizona Independent Scheduling Administrator

Please address whether Arizona's Constitution prohibits the Commission from giving up *any authority* with respect to the pricing of services by public service corporations which occur solely within the state.

Should Arizona be willing to let the federal government take over pricing jurisdiction (market based rates) for all retail transactions which occur in the state, or is this an inevitable (and proper) result of opening retail markets to competition?

Can Arizona's UDCs modify their tariffs with the FERC to conform with AISA protocols so that retail transactions can still take place without the AISA? How many times has the AISA been used to resolve disputes over transmission issues to date?

Since these are essentially legal and jurisdictional questions, AUIA will defer to the transmission operators and other parties who are better equipped to respond to these issues. However, it appears to AUIA that these questions may overstate the problem of FERC jurisdiction over retail transactions.

SECTION II. Retail Electric Competition Rules

If the majority of market participants intend to market electricity *only* to industrial, large commercial and load serving ESPs entities (sic), should retail markets be limited by load size to allow those entities with true bargaining power to negotiate Direct Access?

AUIA does not believe that a robust competitive market can be based only on large customers, but at this stage of market development, our answer would be yes. The campaign for deregulation in the 1990s was based on certain assumptions, including these: 1) significant excess capacity in the system; 2) low cost and plentiful natural gas; 3) large users could escape subsidizing small customers; 4) utilities would simply absorb their stranded costs. All of these assumptions proved to be wrong, to the extent that virtually no large customers are utilizing direct access. If the market is too unstable for large users, it is certainly too unstable for residential and small commercial users. In addition, it has not been demonstrated that aggregators can overcome the high transaction costs associated with small customers and we believe that problem may become more difficult as embedded costs are flushed out of utility systems.

What will be a UDC's primary functions in a competitive market?

Essentially what they are today. The UDC will be responsible for building and operating the infrastructure that makes electric service possible and it will be responsible for the security and reliability of its own system. We would include

transmission service in the UDC's responsibilities, except that we can't predict the fate of regional RTOs. If the competitive market is limited to large loads, the UDC will have to secure energy for most of its customers. Regardless of load bifurcation, if the UDC is the designated provider of last resort, it will still have that responsibility. Finally, we would expect UDCs to handle metering and billing for most of their customers because they are the most efficient providers, based on economies of scale.

Is it important to first establish functional wholesale markets before creating robust retail markets in electric generation? If so, why? If not, why?

In 1996, AUIA's published position was that Arizona should not embark on retail competition until a) the wholesale market had matured under open access and b) until retail competition had been in place in California for at least three years. Our concern was and is that if the wholesale market is unstable, retail customers and providers of last resort will suffer, as they did in California. Today, it is obvious that the wholesale markets in the west were incapable of withstanding the destabilizing forces that struck in 2000. There is a body of opinion that it was the exercise of market power that caused the most egregious results. Market power may have contributed, but flaws in California's deregulation scheme were equally at fault. Unfortunately, it is still not clear to us that a seamless and transparent wholesale market is even possible today, given the electric rubble created in California and the continuing crisis in the Pacific Northwest.

When price caps are lifted for the majority of Arizona consumers, what assurance do we have that volatility in the market (for both natural gas and electricity) will not result in unstable or inflated rates? Will the generation price of electricity fluctuate with the price of natural gas?

The obvious response is that there are no guarantees in a competitive market. However, there are mitigating factors in Arizona that limit the state's exposure to market volatility. The first is dedication to supply. Arizona utilities have demonstrated an ability to supply their customers' needs in the worst of times. Moreover, they continue to invest billions of dollars in new generation when they are arguably at risk for doing so under the Commission's Competition Rules. The second is diversity. Yes, the price of electricity will fluctuate with the price of natural gas for those suppliers that are dependent on gas-fired generation. But Arizona's native utilities are invested in a mix of coal, gas and nuclear resources that mitigates the exposure to gas prices. Finally, if the Commission continues to be nervous about the removal of price caps, Arizona Public Service Co., in its variance request, has offered a fail-safe alternative: a purchased power agreement that would lock in the utility's diverse portfolio for its customers at predictable prices.

Should there be a provision added to R14-2-1606(B) which would allow/limit a UDC to contract for wholesale power in three or five year intervals? What would be a proper length for contracts?

If there is any lesson to be learned from the California experience, it is that the UDC shouldn't be hamstrung in its ability to negotiate on behalf of its customers. It must have the flexibility to contract for power on the most favorable basis, whether it is long term or short term. The Commission's rules should not specify limits. Ultimately, the Commission has the authority to review the prudence of purchases in ratemaking.

What are the real benefits to residential customers and small businesses in retail competition, other than consumer choice? Will IPPs market their power directly to retail customers, or are their efforts mainly focused on selling power to wholesale customers?

In theory, the benefits are lower energy costs. But the evidence to date is less than convincing that small customers have much to gain from electric competition. IPPs that are exempt wholesale generators cannot sell to retail customers; they must deal with licensed aggregators. The reliability and security of the transmission and distribution systems also dictates that access to the grid by wholesale generators must be controlled.

Currently, is residential choice a real option? If not now, when?

On paper, there is choice in Arizona today, but no one is selling or buying. We don't know when residential choice will make sense, but we continue to doubt that retailers will overcome the transaction costs involved in residential service, particularly as long as the gap between wholesale and retail prices continues to shrink.

What provisions, if any, are necessary to effectuate a gradual replacement of those existing plants in Arizona which are older, more polluting and less efficient than the newer combined cycle plants currently being built?

We have to understand what the issue is here. If it is petroleum-burning plants within urban areas, only the Legislature can prohibit that use; the Commission does not have that power. If the purported issue is coal-burning units, the premise is simply wrong. First, they are only "less efficient" than combined cycle plants when the price of gas is low. Second, when they employ the latest emissions control technology and are located outside the load centers, they may have no negative effect on the environment. Moreover, fuel diversity is essential to price stability and reliability.

What are the long-term effects of divestiture for APS? How does the Commission guard against a PG&E situation, where the distribution company declares bankruptcy after profits have flowed to its parent holding company?

The most obvious effect is that APS and Pinnacle West Generating units will no longer be under Commission regulation. They will be free to compete in the open market and, theoretically, will no longer be fully committed to the needs of APS' retail customers. However, it's not really that simple. As long as APS is under Commission jurisdiction as the provider of last resort, Pinnacle West will be

motivated to balance the disposition of its resources between prudent marketing initiatives and the needs of its standard offer customers. With regard to the PG&E situation, there was very little direct connection between the sale of its generating assets and the subsequent bankruptcy, except that both were caused by the same legislation. Yes, PG&E was required to sell its fossil-fuel-burning units as a condition of stranded cost recovery and the proceeds went to the holding company. However, the bankruptcy was caused by requirements that the utility could not negotiate long-term contracts and had to buy power from the California Exchange at prices that it could not recover from its retail customers. There a number of ways to avoid such a scenario, including the transaction proposed by APS in its request for a variance from the Competition Rules.

Additional Comment

In his section devoted to **Pricing**, Commissioner Irvin refers to transmission as "a major component of the price ultimately charged to the consumer..." and goes on to press for the establishment of a regional transmission organization. We believe this misconstrues the potential benefits of an RTO. Transmission is not a major cost compared to either generation or distribution. For example, on an APS residential bill averaging 8.1 cents per kWh, transmission accounts for about .52 cents per kWh or 6.4 percent of the total. It is true that equal access is mandatory for a functioning wholesale or retail market and an RTO may help to assure access. An RTO also should be able to resolve some pricing inequities such as pan caking and constrained paths. But the probability is that RTOs will increase the overall cost of transmission, not lower it.

CHAIRMAN MUNDELL'S FIRST SET OF QUESTIONS

I. Identification of Retail Electric Products and Services for Which Competition Could Bring Benefits

A. What are the possible goods and services traditionally provided by the electric utility for which retail competition is possible?

1. All of the generation services are theoretically susceptible to retail competition. A possible exception is must-run generation which is a reliability and security issue best left to the UDCs and Area Control Operators.
2. In general, distribution services are not candidates for competition. Metering is a candidate for competition, although see our comments below. Distributed generation per se also is a competitive service.
3. All of the aggregation services add up to the job description of an ESP under Arizona's rules and form a package of competitive services.

B. For each good or service for which competition is possible, what are the possible benefits of competition for each good and service?

1. It is difficult to forecast price benefits for generation, given the recent volatility on the supply side and fluctuations in the price of natural gas. Prior to 1998, competition boosters were predicting cost reductions of up to 40 percent. Of course, these savings didn't materialize and were confined mainly to mandated rate reductions of about 10 percent incident to deregulation. Price benefits for aggregation services must be gleaned from generation savings.
2. Benefits will vary with market conditions. In theory, price benefits will become more accessible when stranded costs have been recovered and the generation "credit" increases for competitive suppliers.
3. Here we would like to discuss metering and billing. AUIA believes that metering and billing have always been "control" issues for large load aggregators. That is, they want to control the metering and billing information so they can control the customer interface. For residential and small business customers, we think there is no benefit to competitive metering and billing unless the Commission chooses to mandate time-of-use meters. In that case, they would have to work with the UDC anyway as the only regulated entity in the equation capable of carrying out that directive.
4. In the generation arena, experience has shown that a green power marketing niche has a place in the competitive marketplace. In this space, however, we would like to comment on a downside risk associated with competition. That would be the potential loss of diversity of resources. The summers of 2000 and 2001 illustrated the danger in becoming too reliant on natural gas as a fuel source. Yes, there have been charges of capacity manipulation, but there is no question that capacity is strained and getting more so with each new power plant that comes on line. Arizona's diversity of fuels – nuclear, coal and gas -- contributes significantly to reliability and price stability.

II. Determination of the Feasibility of Competition

A. Are the product and geographic markets for the good or service conducive to effective competition or manipulation by a single entity?

1. Absent predatory pricing or restrictive regulation, generation pricing is a function of marginal cost and is plant specific. Although some suppliers may have greater buying power and may benefit from larger and more diverse portfolios, that doesn't imply that economies of scale can dominate the market. With regard to metering and billing, however, the UDCs already operate the most efficient systems because they have 100 percent of the customers.
2. To avoid confusion and maintain system reliability, most generation and aggregation services should be bundled in ESP offerings. Similarly, it makes little sense to separate metering and billing from other regulated distribution services.

B. Are or will there be a sufficient number of competitors in each potentially competitive market?

1. Today, it appears that there will plenty of generators to provide electricity, provided that they can get their product to market. But are there sufficient margins to encourage marketers and consumers to take the plunge? We don't know. Furthermore, the supply equation could change. The market constantly seeks equilibrium and it seems clear that electric competition only works for the consumer when there is excess capacity in the system. Obviously, excess capacity is not the goal of merchant generators. An evident problem is how long it takes the industry to respond to market conditions. If it takes four to five years to plan and build a combined cycle plant and even longer to build a transmission line, one could expect that consumers would experience some cyclical bumps and bruises in a deregulated market.
2. Large loads can be aggregated relatively efficiently, especially for a portfolio of bundled services. However, the transaction costs for aggregating large numbers of small customers appear to be a significant barrier to overcome.
3. The higher you climb on the fuel chain, the more difficult it becomes for new entrants to participate. For example, only a company with significant financial resources (and political will) could marshal the legal and technical knowledge to license and construct a nuclear plant. The fuel, transportation, water and environmental issues involved in building a large coal-fired plant are just a step down from the nuclear experience. Due to long lead times, the market risks may be great. Comparatively speaking, combined cycle plants are a piece of cake.

C. Is it necessary for the product or service to be provided by a single regulated company to assure reliability and safety, or can multiple companies provide the service subject to reliability and safety rules.

In our view, distribution services should continue to be provided solely by existing, regulated UDCs and electric cooperatives. Any other arrangement would compromise reliability and cause customer confusion. As we have stated previously, we would include metering, not because of safety concerns but because there is no clear benefit resulting from competition. Generation (including distributed generation) and aggregation services can be offered by multiple companies, provided that the rules for gaining access to the system are clear and enforceable and provided also that aggregators (ESPs) are certificated by the Commission.

D. For customers, is the cost associated with learning how to shop and actually shopping sufficiently small, relative to the expected benefit, that customers will want to shop?

Unless customers are upset and dissatisfied, we believe that a very small percentage will actually shop for alternate providers. Typically, they don't shop for banking, investment, telephone or insurance services. They have to be contacted and sold and that is why transaction costs for recruiting residential and small business customers may be prohibitive. We have seen survey results indicating that no customers would go through the hassle of changing providers for less than a 10 percent saving and many would not do it for less than 20 percent.

III. Relationship of the Current Regulatory Regime to Competition

A. For each potentially competitive product or service, how does current state and federal regulation foster or inhibit (a) retail competition and (b) wholesale competition?

Competition must be *enabled* in an industry that has been characterized by state-sponsored monopoly for the past 100 years. FERC's open access orders enable wholesale competition, although it can be argued that the transmission grid is inadequate to the task and it is difficult to overcome layers of state and federal approvals to improve it. The Commission's rules enable retail competition in generation and aggregation, although some parties probably will argue that a) the Commission's certification process discourages the entry of new ESPs and b) there is too little incentive in the generation credit to promote competition. At bottom, however, competition has been undermined by market instability and the California debacle. You can enable competition, but you can't make it happen.

B. How can the Commission protect Arizona customers from the risks of competition while promoting competition?

Can you be a little bit pregnant? AUIA believes this is Mission Impossible. Markets react to real events, not to promises and theories. That is one of the reasons that nothing was built in the 1990s while competition was being formulated. We do not understand how Arizona can maintain a competitive

retail market when no other western state is participating and particularly without California. In the current market environment, the Commission's Competition Rules may expose the utility companies and their customers to unacceptable risks with regard to electric supplies and prices. Having said that, it is certainly possible for the Commission to take baby steps, such as: bifurcate the market by load size or adopt a phased approach such as the one proposed by APS in its request for a variance. In the meantime, monitor the wholesale market and RTO developments and see what shakes out in California and other states.

C. How have the interim rate reductions for customers receiving standard service affected the ability or desire of generation suppliers to compete in Arizona retail markets?

Given the volatility of the market during the last two years, it is doubtful that the rate reductions have had a material effect on competitive retail offerings. Under more normal circumstances, they would probably make it more difficult, but not impossible, to market a competitive product. By all accounts, that was the case in California before that market imploded.

D. Do Commission policies or legal requirements ensuring that utilities recover investments from ratepayers affect the prospects for competition in any market for which competition otherwise would be possible?

It can be argued that mechanisms to supplant these requirements, such as stranded cost recovery, may slow the rate at which competition takes hold, but it is largely impossible to measure against the recent backdrop of market volatility. Of course, if the courts should finally determine that the Commission has abrogated its Constitutional duty to establish just and reasonable rates, then the Arizona Constitution will have to be amended to enable retail competition.

E. Does continuing utility control of depreciated generation assets affect the ability of competing suppliers to enter retail markets?

We assume that this question refers to assets other than must-run units. If the Commission's rules contemplated "continuing utility control" of major generation assets, it would have a negative impact on potential competitors, but the rules require separation of generation from the UDC.

F. How does current Commission regulation promote or deter the ability of (1) renewables, (2) distributed generation, and (3) energy efficiency and demand side management to compete with traditional generation resources?

We have discussed renewables in response to Commissioner Spitzer's questions and AUIA is not sufficiently informed to discuss energy efficiency and demand side management. However, AUIA participated in the Commission's extensive working group on distributed generation. The record of the working group demonstrates that to enable widespread use of distributed generation would require rulemaking and tariff filings to clarify numerous issues like planning and notification, access to the grid, security, standby pricing and potential stranded

costs. We doubt that distributed generation will become widespread until present techniques are replaced by affordable fuel cell technology. AUIA is constrained to point out that Article 15, Section 3 of the Arizona Constitution does not empower the Commission to promote one form of generation or energy usage over another, nor does it authorize the Commission to set the conservation policies of this state.

G. What are the risks of moving to a regime of retail competition for each product or service and what are the methods for managing those risks?

For generation services, the risk inherent in the Commission's Competition Rules is that the utilities and their customers will be exposed in the marketplace to inadequate or unreliable supplies of electricity, prices that are higher than their own generation costs and higher costs than they can recover under current retail rates. As we indicated in III B, it may be feasible to mitigate the risks by bifurcating the market, adopting a new phase-in schedule or by granting the variance requests already submitted by the utilities.

H. If the current regime is not conducive to retail competition for a particular product or service, what actions should the Commission take to promote its success in the future? Specifically --

1. Should the Commission require existing utilities to procure particular products or services from unaffiliated competitors?

This question highlights the conundrum facing the Commission and its regulated utilities. Arizona is one of the fastest growing electric markets in the country and it has had some very close calls in meeting peak demand during the past two summers. Retail competition is available in Arizona, but there are no participants. The incumbent utilities are also the designated providers of last resort. In these circumstances, the utilities have no choice but to plan for and invest in generation and transmission facilities as if they are solely responsible for meeting their customers' needs, because they are! Meanwhile, the Commission's Competition Rules require the utilities to put half of their electric load up for grabs beginning next year. That is comparable to putting half of their generation assets at risk while they are in the process of building even more. Financial markets hate uncertainty. For example, analysts who have contacted AUIA have expressed concern that the assets of Pinnacle West are at risk and they view APS' request for a variance form the Competition Rules as a measure to mitigate that risk. Of course, when price caps are removed, the risk transfers directly to consumers.

2. Are utilities taking steps that will make competition more difficult... etc.?

AUIA has insufficient information to comment on this question.

3. Are utilities entering into long-term contracts with existing customers? Etc.

AUIA has insufficient information to comment on this question.

4. Should the Commission consider instituting competition for billing and metering services even if retail generation competition is premature?

We do not understand what this would accomplish for the consumer. In Pennsylvania – arguably the only moderately successful experiment with retail competition in the country – the major utilities are taking significant steps to upgrade their metering systems with features like remote reading. Conventional wisdom has it that they are responding to the competitive environment. Nevertheless, it is the incumbent utilities that are doing it.

IV. Retail Generation Competition

Although AUIA has a general understanding of these issues, some of the questions in this section call for a level of specificity which AUIA cannot provide. In other cases, the questions call for information that will be the subject of litigation in Docket No. E-01345A-01-0822. Therefore, AUIA will refrain from responding to this section.

V. Industry Events External to Arizona

AUIA will also refrain from responding to this section except for Question B. We will note that some very smart people in California and Texas thought they could predict the future and you have seen the results.

B. Is there anything the Commission should do to continue to avoid California's retail electric competition experience? Please be specific.

If the Commission continues down the path to electric competition, it should:

- Be patient until market conditions are more clear.
- Take baby steps.
- Closely monitor wholesale markets and RTO developments.
- Closely monitor UDC supply and demand projections.
- Allow UDCs flexibility in meeting their customers' needs.
- Consider re-instituting the purchased power and fuel adjustment clause.
- Develop standards for judging the prudence of power supply decisions by UDCs.

The Commission should not:

- Continue price caps beyond their expiration.
- Require UDCs to purchase from a central power exchange.
- Direct where UDCs must obtain power for standard offer customers.

VI. System Security

AUIA does not have sufficient information to respond to this section.

VII. Vision

Please provide your vision for how viable competitive wholesale and retail electric markets will (or will not) develop in Arizona. Please be specific regarding dates, the development process, and measures for determining at various stages how successful the process has been.

The wholesale market in Arizona and elsewhere in the west is already viable, although it is volatile and may be skewed by the fact that the State of California is brokering electricity for its consumers through long-term contracts. Operation of the wholesale market could improve when RTOs are brought on line and when a few western transmission bottlenecks are cured. These developments could be achieved in three to five years but will probably take longer.

The provision in the Competition Rules that requires utilities to bid out 50 percent of their load in 2003 only serves to force feed wholesale competition, which is unnecessary and an inappropriate intercession by the Commission. It has nothing to do with implementing retail competition for Arizona consumers and, in fact, it may expose incumbent utilities and their customers to serious risk. It puts the Commission in the position of promoting the business of companies that are not even under its jurisdiction at the expense of those that are.

It must be evident that AUIA is skeptical about the development of retail competition in the wake of the California debacle and its repercussions throughout the west. As we have said previously, we think it is inadvisable for Arizona to force feed competition unilaterally, and no other state on the western grid is even considering retail competition.

On the other hand, all of the elements to enable retail competition have been in place for two years and no harm has occurred. There are simply no takers. We cannot predict what event(s) will trigger a renewed interest in retail competition or when it will occur. In some cases, expiring contracts may provoke new interest. We expect that competition will become somewhat more viable when the utilities' competitive transition charges are removed (in 2006 for APS), providing a larger shopping credit. However, the prevailing market price will be the final determinant.

Although we are the house skeptics, AUIA sees no compelling reason for dismantling the Competition Rules at this time. With the exception of the aforementioned bidding provision, the rules could stay in place until the settlement agreements run their course and we'll see what happens. The simple existence of customer choice will help to keep prices down.

CHAIRMAN MUNDELL'S SUPPLEMENTAL QUESTIONS

AUIA will defer to other parties which are more conversant with the legal and regulatory issues underlying most of these questions. However, we would like to comment briefly on Question 14.

14. How would the divestiture or transfer of assets of vertically integrated utilities now serving Arizona affect the Commission's regulatory authority over the divested entities? What controls or limitations might the Commission place on divestiture or transfer of assets to limit any loss of authority over the divested assets?

When these assets are spun off to an affiliated entity, the Commission will have no direct regulatory authority over them. But then, it doesn't now. The Commission already has declared generation to be a competitive service, not under the Commission's regulation. There is also appellate law in this state which places the disposition of a public service corporation's assets beyond Commission control. The Commission's real control over generating assets is through ratemaking, where the prudence of the UDC's power acquisition costs are always open to scrutiny. However, as we have said elsewhere, if the Commission is deeply concerned that generation assets may somehow become disconnected from the Arizona customer base, it should consider a form of purchased power agreement such as that proposed by APS in its request for a variance.